Supreme Court, U.S.
FILED
FEB 26 1986
JOSEPH F. SPANIOL, JR.
CLERK

No. 84-1944

In the Supreme Court of the United States

OCTOBER TERM, 1985

UNITED STATES OF AMERICA,
ET AL., APPELLANTS

v.

ALVIN HEMME, ET AL.

ON APPEAL FROM
THE UNITED STATES DISTRICT COURT FOR
THE SOUTHERN DISTRICT OF ILLINOIS

REPLY BRIEF FOR THE UNITED STATES

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This case is here on direct appeal because the district court held that Section 2010(c) of the Internal Revenue Code[1] is a species of retroactive legislation whose application to appellees was so arbitrary and capricious as to deprive them of property without due process of law. We showed in our opening brief that the district court was wrong for at least four independent reasons. Evidently recognizing the vulnerability of the district court's constitutional holding, appellees in their brief do not place chief reliance upon it. Instead, they principally urge a statutory argument, a variant of which they proffered first in their claim for refund and then to the district court, but upon

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[1]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

which the district court did not explicitly pass. Appellees are seconded in this course by an amicus curiae who shares our view that "Section 2010(c) * * * does not implicate constitutional concerns of retroactivity under any view of the law," but who "is concerned that * * * the Court could inadvertently make an overly broad ruling" on the constitutional issue. Paluch Am. Br. 2, 17.[2]

An appeal under 28 U.S.C. 1252 "brings before this Court not merely the constitutional question decided

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[2]Amicus recites that the source of her concern is a pending tax refund suit in which she contends that "Congress's retroactive elimination of [an estate tax] exemption is constitutionally [im]permissible" (Paluch Am. 2 & n.2). Examination of the pleadings in that suit discloses that it is an outgrowth of *Haffner* v. *United States*, 585 F. Supp. 354 (N.D. Ill. 1984), aff'd, 757 F.2d 920 (7th Cir. 1985). The district court in *Haffner* held that certain state and local housing bonds are exempt from federal estate tax by virtue of a 1937 housing law. While the government's appeal from that judgment was pending, Congress legislatively overruled the decision. Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 641, 642, 98 Stat. 939. In so doing, Congress expressed concern about the possible revenue consequences of the *Haffner* decision, in view of the fact that many millions of dollars in such bonds were still in circulation. See Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 971-973 (Joint Comm. Print 1985). Section 641(b)(1) of the legislation (98 Stat. 939) generally made the new law effective with respect to decedents dying, gifts made, and transfers made on or after June 19, 1984. Section 641(b)(2), however, provided (98 Stat. 939) that the new law would also apply if an estate or gift tax return had been filed at any time showing a transfer of such bonds as subject to federal estate or gift tax; the effect of this latter provision was to bar refund claims by taxpayers who lacked the foresight to assert ab initio the tax exemption that the district court discovered in the 1937 law. Amicus curiae and others (see Paluch Am. Br. 2-3) are challenging the constitutionality of Section 641(b)(2) on retroactivity grounds. Although we believe that the Seventh Circuit erred in affirming the district court's judgment in *Haffner* (see 757 F.2d at 921-922 (Posner, J., dissenting)), we did not petition for a writ of certiorari because of the absence of a circuit conflict and because the 1984 legislation had reduced the decision's serious revenue implications.

below, but the entire case," including "nonconstitutional grounds presented to, but not passed on, by the lower court." *United States* v. *Locke*, No. 83-1394 (Apr. 1, 1985), slip op. 7. Whether the Court will consider questions of the latter sort generally "depends on the extent to which lower court factfinding and analysis * * * will be necessary or useful to [the] disposition of those questions" (*id.* at 7 n.9). Although the statutory argument that appellees present here (Br. 15-27) differs somewhat from the statutory argument that they presented in their claim for refund (see J.A. 20-22) and in the district court (see U.S. Br. 13-17), the two arguments have the same basic thrust, and the stipulated facts present no complexity. In these circumstances, we submit that it would be appropriate for the Court to consider and reject appellees' statutory argument, and that there is no need for a remand.

1. Section 2010(c) provides that the unified credit "shall be reduced by an amount equal to 20 percent of the aggregate amount *allowed* as a specific exemption under section 2521 (as in effect before its repeal by the Tax Reform Act of 1976) with respect to gifts made by the decedent after September 8, 1976" (emphasis added). The statutory argument now advanced by appellees (Br. 12-27) and by amicus curiae (Paluch Am. Br. 6-15) hinges on the proper construction of the word "allowed." They contend that Hirschi (the decedent) derived no benefit from his election of the specific exemption in September 1976, and hence that the exemption was not "allowed" to him within the meaning of the statute. Both the premise and the conclusion of this argument are false, and the conclusion in any event does not follow from the premise. We consider them in reverse order.

a. When Hirschi filed his gift tax return (J.A. 8-9) on September 30, 1976, he reported total gifts in the amount of $45,000. He excluded the first $15,000 by virtue of the annual per-donee exclusion, and he claimed a specific

exemption in the amount of $30,000 as to the balance. He thus reported taxable gifts of zero and no gift tax due (*id.* at 9).

Appellees appear to concede (Br. 18 & n.13), as they must, that Hirschi's claim of the specific exemption was not disallowed by the IRS, since his gift tax return was accepted as filed and since no deficiency in gift tax was proposed or assessed.[3] Appellees nevertheless contend that Hirschi's claim was "effectively disallowed" (Br. 14, 18) or "was, in effect, never allowed" (*id.* at 16) because the property as to which he had claimed the specific exemption was ultimately included in his gross estate as a gift "in contemplation of death" (26 U.S.C. (1976 ed.) 2035)). In appellees' view, an exemption or deduction is not "allowed" for federal tax purposes unless the taxpayer has "benefited from [its] use" (Br. 8).

Appellees' argument is squarely foreclosed by this Court's decision in *Virginian Hotel Corp.* v. *Helvering*, 319 U.S. 523 (1943). The question there concerned the determination of a taxpayer's "basis" in property for purposes of computing depreciation upon it. The Code then provided, as there relevant, that the basis of property was to be adjusted for depreciation " 'to the extent allowed' " in prior years under the tax laws (319 U.S. at 525 & n.5, quoting 26 U.S.C. (1940 ed.) 113(b)(1)(B)). The taxpayer in *Virginian Hotel* had claimed deductions for depreciation in prior years, and "[n]o objection [had been] taken by the Commissioner or his agents to the amounts [thus] claimed and deducted" (319 U.S. at 524). The taxpayer nonetheless

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[3]Appellees state (Br. 18 n.13) that "[t]he Service could have disallowed Mr. Hirschi's claimed specific exemption and [could have] assessed a deficiency with respect to [his] gift tax return" before the statute of limitations barred such action. But they do not suggest any ground on which the Commissioner could have predicated such action, nor do they suggest that he took such action in fact.

contended that the basis of its property should not be reduced on account of those previously-claimed depreciation deductions, since, owing to operating losses in the earlier years, the depreciation "did not serve to reduce [its] taxable income" (*id.* at 525). The taxpayer contended, in short, that the term " 'allowed' * * * connotes the receipt of a tax benefit," and that a deduction "claimed by [a] taxpayer and not disallowed by the Commissioner * * * is nevertheless not 'allowed' if * * * deductions other than depreciation are sufficient to produce a loss for the year in question" (*id.* at 526).

This Court squarely rejected the taxpayer's argument (319 U.S. at 527-528 (footnote omitted)):

> Under our federal tax system there is no machinery for formal allowances of deductions from gross income. Deductions stand if the Commissioner takes no steps to challenge them. Income tax returns entail numerous deductions. If the deductions are not challenged, they certainly are "allowed," since tax liability is then determined on the basis of the returns. Apart from contested cases, that is indeed the only way in which deductions are "allowed." And when all deductions are treated alike by the taxpayer and by the Commissioner, it is difficult to see why some items may be said to be "allowed" and others not "allowed." It would take clear and compelling indications for us to conclude that "allowed" as used in § 113(b)(1)(B) means something different than it does in the general setting of the revenue acts.

Citing *Virginian Hotel,* the lower courts have consistently held that deductions are "allowed" for federal tax purposes when they are claimed on a tax return "without objection by the Commissioner" (*Blackhawk-Perry Corp.* v. *Commissioner,* 182 F.2d 319, 321 (8th Cir. 1950)), and that "[i]t is

immaterial that the taxpayer * * * derived no tax benefit from the allowance." *P. Dougherty Co.* v. *Commissioner,* 159 F.2d 269, 271 (4th Cir. 1946). Accord, *e.g., Kilgroe* v. *United States,* 664 F.2d 1168, 1170 (10th Cir. 1981); *Repplier Coal Co.* v. *Commissioner,* 140 F.2d 554, 558 (3d Cir. 1944).

Although appellees acknowledge the force of this Court's decision in *Virginian Hotel,* they seek to distinguish it from this case on the ground that it involved the income tax rather than the gift tax. See Br. 18 & n.14. But this is a distinction without a difference. The Court in *Virginian Hotel* spoke of "our federal tax system" (319 U.S. at 327), and precisely the same "machinery" (*ibid.*) governs the audit of income tax returns and gift tax returns, as well as the allowance or disallowance of deductions, exemptions, and exclusions claimed upon them. It has always been true, since the enactment of the gift tax in 1932, that otherwise taxable gifts as to which the specific exemption (or, where appropriate, the annual exclusion) had been claimed, might subsequently be included in the donor's gross estate, *e.g.,* as a gift in contemplation of death (26 U.S.C. (1976 ed.) 2035) or as a transfer with retained life interest (I.R.C. § 2036). It has never been suggested that a claimed exemption or exclusion, unchallenged by the Commissioner, should in such circumstances be deemed "disallowed." Indeed, the credit for gift taxes, as applied against the estate tax, was likely to be reduced in such circumstances by virtue of the decedent's claim of, and the Commissioner's lack of objection to, the specific exemption or annual exclusion, even though the taxpayer arguably received no "tax benefit" therefrom. See, *e.g., Estate of Chapman* v. *Commissioner,* 32 T.C. 599 (1959) (gift in contemplation of death); Treas. Reg. § 20.2012-1(c) (computation of gift tax credit where gift made in contemplation of death).

When Congress has intended to qualify the word "allowed" in the manner that appellees urge, Congress has done so in plain and unambiguous terms. The word "allowed" is a term of art in the Internal Revenue Code. It is the operative verb in virtually every section that provides for a deduction. *E.g.*, I.R.C. § 165(a) ("There shall be allowed as a deduction any loss sustained during the taxable year * * *."). And its meaning is crucial to the operation of the Code's "basis" rules. See, *e.g.*, I.R.C. § 1016(a)(20) (adjustments to basis "for amounts allowed as deductions for payments made on account of transfers of franchises, trademarks, or trade names"); I.R.C. § 1016(a)(25) (adjustments to basis "for amounts allowed as deductions under section 58(i) (relating to optional 10-year write off of certain tax preferences)"). When Congress has intended, as it has intended with respect to several of these basis provisions, to incorporate the "tax benefit" gloss that appellees seek to find in Section 2010(c), Congress has specified that basis shall be reduced "for amounts allowed as deductions * * * *and resulting in a reduction of the taxpayer's taxes under this subtitle.*" *E.g.*, I.R.C. § 1016(a)(9), (14) and (16) (emphasis added). See I.R.C. § 1016(a)(2)(B) (depreciation deductions). Congress obviously has incorporated no such language in Section 2010(c), and there is thus no reason to give the term "allowed" as used therein a construction different from the long-familiar construction adopted by this Court in *Virginian Hotel*.

In sum, there is no merit to appellees' contention that a specific exemption, properly claimed by a donor on a gift tax return, should be deemed "allowed" within the meaning of Section 2010(c) only if it can be shown to have generated a tax benefit to him or to his heirs. As we pointed out in our opening brief (at 15-16), the statutory argument that appellees made below, which resembles their argument here, has

been rejected by the only other court that has considered it. See *Estate of Renick* v. *United States*, 687 F.2d 371, 376-377 (Ct. Cl. 1982). This Court should reject it also.[4]

b. The premise of appellees' statutory argument—that Hirschi obtained no benefit from his election to claim the $30,000 specific exemption on his September 1976 gift tax return—is in any event incorrect. By virtue of that election, Hirschi paid no gift tax, which otherwise would have been currently due, on the transfer of property then valued at $30,000. By virtue of that election, he obtained the certainty that the property in question would reach his heirs entirely free of tax—both of gift tax and of estate tax—if he survived for three years or died under circumstances negating the inference that he had transferred the property in

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[4]As we have noted (U.S. Br. 6-7), the House Report on H.R. 14844, 94th Cong., 2d Sess. (1976), discussing an earlier version of Section 2010(c), illustrated its operation by stating: "Thus, in the case where a donor *had benefited* from the use of the full $30,000 gift tax specific exemption under present law, the maximum unified credit allowable would be reduced by $6,000." H.R. Rep. 94-1380, 94th Cong., 2d Sess. 16 (1976) (emphasis added). Contrary to the contention of appellees (Br. 7-8) and of amicus curiae (Paluch Am. Br. 10-11), this passage does not support the construction of the statute that they urge. In the common situation, of course, a decedent *would have benefited* from the use of the specific exemption, and it was thus natural for Congress to invoke that situation when illustrating the mathematics required. But Congress's reference to that fact pattern by way of example hardly constitutes a "clear and compelling indication * * * that 'allowed' as used in [Section 2010(c)] means something different than it does in the general setting of the revenue acts" (*Virginian Hotel*, 319 U.S. at 527-528). Both the House Report (H.R. Rep. 94-1380, *supra*, at 16) and the Conference Report (S. Conf. Rep. 94-1236, 94th Cong., 2d Sess. 607-608 (1976)), like Section 2010(c) itself, state without qualification that the unified credit is to be reduced by reference to amounts "allowed as a specific exemption," and there is no justification in either the statutory language or its legislative history for concluding that Congress did not mean what it said.

contemplation of death.[5] And even if some estate tax, possibly greater or possibly less than the avoided gift tax, ultimately became payable, Hirschi obtained by virtue of his election both a temporal deferral of the tax and a shift in its incidence from himself to his estate. Owing to the time value of money, deferral of taxes is a benefit that taxpayers often seek, even at the cost of extensive litigation. See, *e.g.*, *United States* v. *Hughes Properties, Inc.*, cert. granted, No. 85-554 (Dec. 2, 1985).

With respect to gifts made between September 8, 1976, and January 1, 1977, an analytical taxpayer might have found that ascertaining the balance of benefits and burdens concerning election of the specific exemption was a complex task calling for subtle judgments. Among the factors to be considered would have been the donor's age and the state of his health, the prevailing and anticipated level of interest rates, the gift tax bracket into which prior taxable gifts had placed him, and the anticipated size of his estate. Since election of the specific exemption would produce a 20% reduction in the unified credit, it might have seemed prudent, other things being equal, for a donor in a gift tax bracket below 20% not to claim the specific exemption, but instead to pay the relatively small gift tax that would then

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[5]Appellees appear to suggest (Br. 12, 16) that Hirschi's September 1976 gifts were *automatically* included in his gross estate because made within three years of his death. But while automatic inclusion is the rule for gifts made after December 31, 1976 (see I.R.C. § 2035(a)), gifts made before 1977 and within three years of death were merely *presumed* to have been made in contemplation of death, "unless shown to the contrary" by the taxpayer (26 U.S.C. (1976 ed.) 2035(b)). Thus, the includability of Hirschi's September 1976 gifts in his gross estate ultimately depended (subject to the presumption in former Section 2035(b)) on a factual determination as to whether those gifts were actually made "in contemplation of death." See *Estate of Hutchinson* v. *Commissioner*, 765 F.2d 665 (7th Cir. 1985); *Estate of Gill* v. *Commissioner*, 79 T.C. 437 (1982), aff'd, 711 F.2d 541 (5th Cir. 1983).

have been due. In that way, the donor would keep his unified credit intact, while preserving for his executor the right to claim a credit for the gift tax paid should the transferrred property ultimately be included in his estate. If a donor in a gift tax bracket below 20% (as Hirschi was) were to elect the specific exemption in such circumstances (as Hirschi did), his election would suggest—if we again assume an analytical and well-informed taxpayer—that he placed a high priority on deferring even a relatively small amount of tax, that he was especially confident of surviving for three years or more, or that he was similarly confident that his taxable estate would be small enough so that the reduction in the unified credit would not matter.

Whatever the balance struck by a given taxpayer, the significant fact is that the statute left him free to make an election in light of his circumstances and values, as he perceived them. The statute did not undertake to guarantee that his choice would be wise, or that his estimate of the probabilities would be borne out. There is nothing in this case to indicate that Hirschi ever regretted his election of the specific exemption on his gift tax return for the third quarter of 1976, filed as it was some hours before the end of that quarter. Nor is there anything to suggest that, prior to the November 15, 1976, due date for such returns, Hirschi wished or sought to withdraw the return that he had filed or the election that he had made. After his death, his executors have apparently recognized that, as matters eventuated, another election would have produced fewer dollars payable to the Treasury. But their hindsight does not change the fact that Hirschi during his life enjoyed the benefits—including tax deferral—of the election that he freely made.

2. As to the constitutional question, we believe that our opening brief covers most of the issues that appellees have raised. Two points, however, merit a short reply.

a. We pointed out in our opening brief (at 17-18) that the Tax Reform Act of 1976, Pub. L. No. 94-455, Tit. XX, 90 Stat. 1846 *et seq.*, cannot be said to have deprived appellees of property, since the overall effect of that law, including Section 2010(c), was, as appellees conceded in their motion to dismiss, to "reduce[] the decedent's estate tax by $655.16" (Mot. to Dis. 6). Appellees in their brief on the merits assert somewhat confusingly that our argument "fails to consider the increase of $6,000 in taxes payable by the estate due to reduction of the unified credit" (Br. 38). This assertion on its face is incorrect. The $655.16 tax reduction to which we refer represents the *net* tax savings to appelleess *after* the assessment of a $6,000 tax deficiency stemming from reduction of the unified credit. See U.S. Br. 18. It is of course true that, if Section 2010(c) had not been included in the 1976 Act, the overall effect of that law would have been to reduce appellees' estate tax by $6,655.16 rather than by $655.16. But prior to that law's enactment appellees had no more of a property right in the former sum than they had in the latter, and they had no vested interest in any particular version of the bill that Congress was considering. Appellees may have hoped for a greater tax reduction than they got, but the disappointment of their hopes did not work a deprivation of their property.

b. Appellees appear to agree with our contention (U.S. Br. 23-24 & n.12) that *Untermyer* v. *Anderson*, 276 U.S. 440 (1928), the decision upon which the district court chiefly relied in declaring Section 2010(c) unconstitutional (see J.S. App. 4a-5a), has been limited by this Court's subsequent decisions to the precise facts that *Untermyer* involved—viz., the retroactive application of a *wholly new tax* to transactions irrevocably completed before its effective date. Appellees, however, seek to bring this case within the reach of *Untermyer*, as thus limited, on the theory that Section 2010(c) "effectively imposes a retroactive penalty tax" and

thus "imposes a totally new and different tax" upon them (Br. 33). The subject of this supposed "retroactive penalty tax" is said to be a donor's "recognized right, in effect [prior to 1977], to make up to $30,000 in gifts, claim [a specific] exemption from gift taxes in respect of those gifts, and suffer no potential increase in estate tax by virtue of the claimed exemption" (*id.* at 31-32).

Appellees' argument reminds one of Voltaire's remark about the Holy Roman Empire. Section 2010(c) does not "impose a tax"; it provides for a reduction of a credit against a tax on account of a tax benefit previously claimed and allowed. Section 2010(c) does not effect a "penalty"; penalties under the Internal Revenue Code are clearly denominated as such (*e.g.*, I.R.C. §§ 6671-6708), and Section 2010(c), far from imposing a penalty, sets forth a transitional rule of general application to prevent a lacuna between two tax regimes. And Section 2010(c) is not "retroactive" legislation because, as we showed in our opening brief (at 18-21), it was enacted more than two years before the testator died.

For these reasons and for the reasons set forth in our opening brief, the judgment of the district court should be reversed.

Respectfully submitted.

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FEBRUARY 1986

DOJ-1986-02